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TESTIMONY BEFORE THE TRADE DEFICIT REVIEW COMMISSION

by

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I appreciate the opportunity to testify today, before the Commission. Over the last ten years, I have worked and written extensively on a number of topics related to U.S. trade policy toward China. I have thoughts on a number of issues raised here today, including the large and growing U.S. bilateral trade deficit with China.

Given time limitations, however, I plan to focus my remarks on the World Trade Organization (WTO) accession agreement with China and, more specifically, the enormous problems that the United States and the WTO are likely to face in enforcing that agreement.

THE WTO ACCESSION AGREEMENT

Trade agreements are by their nature compromises. As a result, they are normally not "perfect" from any individual perspective. The agreement with China is no exception. Unquestionably, a number of provisions could be improved. Chinese tariffs could be lowered beyond the 17 percent China has agreed to. Foreign telecommunications firms and banks could be granted more leeway to operate in China.

It is possible that subsequent negotiations between China and other WTO members may improve the terms on these or other issues.

On paper, however, the "deal" negotiated between Washington and Beijing has a good deal to commend it. China does agree to substantial tariff cuts. China does commit to substantial new market access for agricultural products. U.S. banks and insurance firms are promised substantially increased access to Chinese consumers.

Unfortunately, the problem in negotiating trade agreements with China in recent years has not been convincing China to promise improvements. It has been getting China to fulfill its promises. Already, Chinese press reports indicate that China does not plan to rigorously fulfill the agricultural provisions in the WTO accession agreement.

A careful examination of the four recent major trade agreements the United States has struck with China strongly suggests that compliance problems have been serious.

INTELLECTUAL PROPERTY – 1992

One of the best-known agreements between the United States and China involves protection of intellectual property -- patented, copyrighted, and trademarked material. The United States has sought improved protection of intellectual property from China for many years.

After the threat of sanctions, the Bush administration convinced China to undertake a sweeping update of its laws protecting intellectual property. China brought its intellectual property protection regime largely into compliance with accepted western norms.

Unfortunately, these legal changes had little discernible impact on the ground. Chinese piracy of music recording, computer programs, and films grew at an alarming rate at least through the mid-1990s. Movies and computer programs made by Chinese pirates turned up as far away as Canada and Eastern Europe.

After trying to address matters through quiet consultations, the Clinton administration threatened to impose trade sanctions in 1995 unless the situation improved. As the deadline for sanctions approached, China agreed to step up enforcement efforts.

A year later, however, it was apparent that China's promises had resulted in little improvement. Once again, the Clinton administration threatened sanctions. After much complaint, the Chinese agreed to a much more specific enforcement regime.

With consistent pressure from the United States, China has regularly produced records of pirate operations shut down and held press demonstrations with steamrollers crushing pirated CDs. Although these demonstrations do show at least some ongoing effort to attack the problem of piracy, they also demonstrate that piracy continues at a

high level. Although it is difficult to precisely measure, U.S. pressure has won some results. but *the U.S. industry estimates that losses to piracy today are greater than they were when the topic of enforcement was raised in 1995.*

Two points warrant further attention in the context of enforcement.

From the outset, it has been clear that provincial leaders, the families of leading Chinese officials, and even the Chinese military have been directly involved in intellectual property piracy. Pirates reportedly set up facilities to make illegal CDs on People's Liberation Army bases. Apparently, citing operations on PLA bases was a particularly effective method to avoid internal security police that aimed to shut down pirate facilities. In short, piracy of intellectual property, has not been solely the province of street level criminals, elements of the Chinese government also appear to be involved in piracy.

Secondly, one intellectual property problem directly involves the government. One item that Chinese officials explicitly promised to address in 1995, 1996, and again in March of 1999 is that of government Ministries using illegally copied computer software. According to first hand reports, government ministries routinely illegally copy computer software for their use. Such an ongoing problem within the government calls into question the sincerity of China's commitment to fulfill its agreement with the United States on intellectual property protection.

In many ways, the efforts made to enforce the agreement on piracy, of intellectual property are unique. Both the private sector and the Clinton administration have made enforcement of this agreement a priority for the better part of a decade. Still, glaring enforcement problems remain. If it had not been for the ongoing, high-level enforcement effort by the United States, there is no reason to believe that China would have made a serious effort to fulfill the promises made in 1992.

MARKET ACCESS -1992

Unfortunately, the high level commitment made to enforce the intellectual property agreement has not been repeated on other agreements, A sweeping agreement struck with China in 1992 on market access issues is a case in point.

Through the early 1990s, China followed an unabashedly protectionist trade policy excluding many foreign products with a number of trade barriers. Under threat of sanctions similar to those used on intellectual property, the Bush administration successfully negotiated a sweeping market access agreement with China aimed at lowering trade barriers and creating new opportunities for U.S. exports.

In it latest reports on the subject, the Clinton administration states that China has ‘-generally’ fulfilled its commitments. On some of the easily verifiable matters covered by the agreement, like elimination of formal barriers and lowering tariffs, China does seem to have implemented the agreement. In a number of other areas, however, there

have been glaring and obvious problems. Due to space limitations, only three – all acknowledged by the Clinton administration -- will be discussed here.

First, China agreed in 1992 to eliminate all import substitution policies – policies that aim to substitute domestic production for imports. In formal state plans on automobiles and pharmaceuticals approved by Chinese economic policy makers at the highest levels, import substitution requirements were specifically included. Similar policies are included in lower level Ministry directives on a number of products, including power generation equipment and electronics products.

Import substitution is perhaps the most direct form of protectionism possible and it was officially renounced in 1992. Still, time and time again the Chinese government has ignored this commitment.

China also agreed to phase out an entire class of barriers, import licenses, and not raise new barriers. Shortly, after import licenses were phased out, however, China announced a suspiciously similar set of import registration requirements for many of the products previously covered by import licenses. A number of new trade barriers on products ranging from electricity generating equipment to pharmaceuticals have also sprung up.

Finally, China agreed to make all laws and regulations relevant to foreign trade public – a major change in a country where many regulations and policies are not made

part of the public record. Many such directives are now publicly available. Yet, this seemingly elementary provision has also not been implemented in a number of areas, including government procurement regulations.

Taken separately, it is difficult to estimate the economic importance of each of these violations. It is clear, however, that they are clear, unambiguous examples of the Chinese government directly violating the terms of the 1992 market access agreement. These charges have been officially made for a number of years, and the Chinese government has offered no denial or explanation.

In their defense, Clinton administration officials argue that it is difficult to pursue these matters because other U.S. government agencies have other priorities and many private sector companies do not support action. It is certainly true that many U.S. companies are not anxious to have the United States threaten trade sanctions that may compromise their business in China to address trade issues that do not directly concern them. For instance, some companies also expressed concern over sanctions to stop intellectual property piracy. If, however, agency indifference and private sector grumbling are sufficient to halt enforcement of trade agreements, it is doubtful that any trade agreements, particularly with countries that are willing to intimidate U.S. companies, will ever be enforced.

TEXTILE TRANSHIPMENT

For decades, trade in textile and apparel has been governed by a special trading arrangement known as the Multi Fiber Agreement (MFA). Under the MFA, importers and exporters of textiles negotiate what amount to specific quotas on textile imports on a bilateral basis. As the world's largest textile exporter and the world's largest importer, China and the United States, respectively, both participate in the MFA and concluded a parallel bilateral agreement in 1994.

For some years, there have been persistent reports of transshipment of textiles and apparel by Chinese entities to avoid MFA limits. In essence, transshipment involves Chinese companies labeling textiles made in China as having originated elsewhere, usually Hong Kong or Macao, to avoid MFA limits. Given the illegal nature of transshipment, accurate figures are not available on the scope of the problem. A past U.S. Customs Commissioner estimated that transshipment from China into the U.S. market amounted to about \$2 billion worth of imports annually. A more recent Customs study noted that as much as \$10 billion in Chinese textile exports were not officially accounted for – much of this undoubtedly found its way into the U.S. market.

This issue deserves particular attention in connection with any discussion on the size of the U.S. trade deficit with China. A number of individuals, I believe incorrectly, argue that the size of the U.S. trade deficit with China is greatly exaggerated. Invariably, the analysts that take this position simply ignore the issue of textile transshipment. If the findings of the U.S. Customs Service are correct with regard to transshipment, it means

that official U.S. statistics on the trade deficit with China actually underestimate the deficit by several billion dollars per year because they overlook Chinese textile exports illegally transshipped through Hong Kong and Macao.

The Customs Service has undertaken a number of enforcement efforts to address transshipment over the years, including reducing China's official MFA quotas as a penalty for transshipment. In 1997, China and the U.S. reached a four-year Textile Trade Agreement that, among other things, reduced quotas in fourteen apparel and fabric categories where there were repeated instances of transshipment and strengthened penalties for transshipment. Nevertheless, in May 1998, USTR and Customs brought action against China for violation of the agreement, imposing \$5 million in charges on textiles illegally transshipped.

Each year, a list of Chinese, Macao and Hong Kong companies involved in transshipment is also released. On the most recent list, 23 of the 26 companies assessed penalties for illegal transshipment were from China, Hong Kong or Macao, and 27 of the 32 companies under investigation were from China, Hong Kong or Macao. Despite these efforts, the problem of transshipment unquestionably continues.

Whatever one's views on the desirability of the MFA, China's record of tolerating massive transshipment of textiles and apparel to avoid MFA quotas is hardly an encouraging example of China's record of trade agreement compliance.

PRISON LABOR

Similar problems have been identified with regard to China's exports of goods made with prison labor. China has an extensive system of prison work camps that produce products ranging from apparel to tools and machinery. Often, prison work forces are leased to private sector firms to assemble or manufacture various products. Under a 1930s U.S. law, it is illegal to import into the United States products made with prison or forced labor.

Over the years, there have been persistent allegations that a number of imports from China violated this law. In 1992, the Bush administration concluded a bilateral agreement to halt the export of forced labor goods to the United States and to hold periodic consultations between Customs officials from both countries.

Despite the agreement, advocacy groups interested in the topic of prison labor have produced evidence that various Chinese companies exporting to the United States are involved in prison labor commerce. found evidence that various products made with prison labor have been imported into the United States, and done hidden camera investigations in China indicating that Chinese companies are prepared to export prison labor products to the United States.

Because it is very hard to distinguish prison labor goods from other goods in commerce, it is impossible to make a credible estimate of the size of the problem. However, the State Department's most recent report on Human Rights Practices in China

found that Chinese cooperation under the 1992 agreement had been “inadequate” and that when complaints were brought by the U.S., “the Ministry of Justice refused the request, ignored it, or simply denied the allegations made without further elaboration.” The report also notes that Chinese officials have attempted to unilaterally define Chinese work camps as not covered by the 1992 agreement -- an interpretation that renders the agreement virtually meaningless.

CAN CHINA BE TRUSTED?

After reviewing the available evidence, it is clear that there have been serious enforcement/compliance issues involving every recent trade agreement concluded with China. In some cases, it can be credibly argued that the agreement still resulted in an on-balance improvement in the relevant Chinese trade practices. That said, China’s implementation fell far short of fulfilling the letter and spirit of all trade agreements. Without an extensive U.S. enforcement effort on intellectual property, most of the progress that has been made would likely never have come about.

China’s defenders often claim that China’s record is no worse than that of other countries. Without question, it is true that a number of U.S. trading partners appear to have cheated on trade agreements over the years. Japan is most often cited as an example.

It is difficult, however, to find another example of a trading partner with which there have been serious compliance problems with every significant trade agreement

negotiated. Further, it can certainly be said that – regardless of problems with other trading partners – the problem with China is serious enough to raise questions about the wisdom of U.S. trade policy toward China. The United States can correctly be faulted for generally placing too much emphasis on negotiating new trade agreements and too little on enforcing the agreements negotiated. That weakness in U.S. trade policy, however, is hardly a reason to ignore trade cheating or negotiate agreements without consideration of enforcement.

The problem of poor enforcement/implementation of trade agreements in China appears to go beyond a simple matter of countries ignoring provisions of trade agreements so as not to offend important domestic constituencies. As many Chinese leaders have conceded China lacks a reliable rule of law. In the trade arena, this means that it is difficult or impossible for any entity in the Beijing government to direct policy changes that bind China's diverse collection of Ministries, State Owned Enterprises, and provincial governments.

Unfortunately, although international pressure may at times be helpful, the WTO is not a magical solution to this problem. The WTO is the ultimate in an international, rule-of-law based institution. It is unclear that it will be able to police a country that operates without a rule-of-law. Trade policies in China are often made in secret without a paper trail. It may well be impossible to even document the existence of objectionable Chinese trade practices much less win a WTO dispute settlement panel against them.

To some, problems of enforcement may seem to be a rather trivial concern. These critics should keep in mind that none of the benefits ascribed to a WTO agreement with China will be achieved without enforcement. In fact, if China simply ignores the terms of the WTO as it has other agreements the benefits could be quite limited: the damage done to the credibility of the WTO under this scenario, however, could be lasting and serious.

Critics would also do well to keep in mind that there is no guarantee that the current relatively reform minded leaders in Beijing will prevail. Given the uncertainties of Chinese politics, it is certainly possible to imagine a much less reform oriented regime, perhaps one led by the military or hard line elements, emerging in China. Instead of using the WTO as a springboard for domestic reform, such a regime could use the WTO as a shield to block foreign sanctions against their policies. Such a regime would pose enormous WTO enforcement problems as well as challenges on many other fronts.

In fact, membership in the WTO will only help Chinese reformers, like Zhu Rongji, reform China's economy if it is enforced. Viewed from this perspective, a vigorous, ongoing effort to enforce the WTO in China may be the best thing the United States could do to further the cause of reform in China.

Unfortunately, as the above examples demonstrate, the record of the United States in carrying out such enforcement efforts is far from reassuring. Historically, efforts to enforce trade agreements have been transient and unpredictable, often blocked by other

government priorities or concerns of some U.S. companies that tough enforcement actions might compromise their specific interests.

In light of this record on enforcement and China's weak compliance record, the Congress would do the United States and, ultimately, Chinese reformers a favor by creating vigorous enforcement procedures as a quid pro quo for approving permanent MFN for China. This could take the form of annual reviews, in which the Congress has a direct role, backed up by the promise of trade action to ensure that enforcement of the WTO remains a priority of the United States.

Given the highly politicized context in which this issue will be considered, it is easy to imagine the discussion being dominated by partisan politics. This would be truly unfortunate and likely result in a poor outcome. All sides would do well to remember that the trade arrangement will last well beyond the election year. China's membership in the WTO seems likely this year, but the task of bringing China into compliance with the WTO's provisions will likely take decades. A successful effort will take the ongoing effort of Congresses and administrations that will not be elected for years to come. If this Congress and this administration can build an ongoing framework to ensure attention to these important issues, they will do future Congressmen, future Presidents, the cause of reform in China, and America as a whole a great service.

Thank you for the opportunity to testify.